CHAPTER 7

SOCIAL SECURITY BENEFIT STRUCTURE

The basic benefit structure of the Social Security system has remained unchanged in principle, though modified in many details, since 1939. Monthly benefits related to the worker's previous earnings are payable to retired and disabled workers, to eligible survivors, and to their families. Benefits based on prior earnings reflect workers' prior standards of living and the earnings from which they paid Social Security taxes. The proportion of previous earnings that is replaced is greater for low than for high earners, a weighting that recognizes the greater economic needs of the person at a low earnings level and also the greater likelihood that higher paid workers will have supplementary pensions and private savings. The precise form and the dollar amounts of the benefit formula have changed many times in the past forty years, but the general principles of earnings-replacement and a weighted benefit formula have retained their validity.

Under the current benefit formula, enacted in 1977 and first applied in 1979, the worker's past earnings are indexed (or updated) to reflect recent wage levels in the economy. Then a monthly average of the worker's indexed earnings is used to compute a basic benefit. The benefit formula for people reaching 65 in 1981 is:

90 percent of the first $211 in Average Indexed Monthly Earnings (AIME), plus

32 percent of the next $1,063 of AIME, plus

15 percent of all AIME over $1,274.[1/]

The worker's basic benefit is reduced for early retirement or increased for delayed retirement (see Chapter 5). Specified fractions of the basic amount are paid to eligible family members. There is a limit on total monthly benefits paid to a worker's family. After a person starts receiving benefits, the amount is adjusted automatically to keep pace with the cost of living.

The Commission considered the structure of the present benefit formula as well as certain alternatives to it. It recognizes that a case can always be made for modifying the formula to meet particular objectives or changing situations. While it encourages continued evaluation of the formula, its general conclusion is that there is no need for modifying it at this time.

However, the Commission is making several recommendations, discussed elsewhere in this report, which affect benefit levels.

1/ The dollar amounts (for the three AIME levels) in the formula are increased each year for successive groups reaching age 62. This adjustment reflects the change in economy-wide wages, and, in that way, updates the formula for each new group of retirees.

They include:

(1) Increasing the special minimum benefit for long-term low paid workers (see Chapter II);

(2) Increasing the delayed-retirement credit (see Chapter 5);

(3) Modifying the automatic adjustment of post-retirement benefits for the cost of living when prices rise faster than wages for an extended period of time (see p. in this chapter);

(4) Improving benefits for widows and widowers whose spouses die long before retirement (see Chapter 1 1);

(5) Reducing the windfall Social Security benefits paid to people who spend most of their working lives in government employment not covered by Social Security, but who also qualify for Social Security benefits (see Chapter 8); and

(6) Increasing the limit on benefits paid to disabled workers' families (see Chapter 9).

Benefit Levels

As instructed by the Congress, the Commission looked at the adequacy of benefits today and as projected for the future. There are various measures of adequacy that can reasonably be used to evaluate benefit levels. The Commission looked primarily at the "replacement rate"--how Social Security benefits compare with recent past earnings--because it indicates the extent to which benefits enable retirees to maintain a standard of living reasonably close to what they achieved before retirement .

Because retirees do not have the work-related expenses that younger workers usually have, nor are their taxes as high, they do not need to have 100 percent of their earnings replaced. The Commission looked instead to net take-home pay--their earned income after taxes and work-related expenses--as a more appropriate measure of pre-retirement standards of living. Table 7-l shows one estimate of net take-home pay as a percent of gross earnings for 1979 at different earnings levels. As the table shows, low earners must have a larger proportion of their previous earnings replaced if their standard of living is not to fall more than that of those who have had higher earnings.

TABLE 7-l

NET TAKE-HOME PAY AS PERCENT OF GROSS EARNINGS

Annual Earnings	Single Person	Married Couple
$4,000.	83%	86%
6,000	80	86
8,000	77	83
10,000	75	81
12,000	73	79
14,000	72	78
16,000	70	76
18,000	69	75
20,000	68	74
25,000	65	71
29,700	62	69

Source: Tables 2.21 and 2.22, Appendix 2-10 in Robert J. Myers, Social Security, Richard D. Irwin, Inc., 1981. Estimates of net take-home pay reflect Old-Age, Survivors, and Disability Insurance and Hospital Insurance employee taxes for 1979; Federal income tax for 1979, assuming standard deductions; and State income taxes for Georgia --which ranks in about the middle of the distribution of State income tax rates. Estimated annual work-related expenses rise from $300 at earnings of $4,000 to $500 at earnings of $14,000, and then remain at $500 at higher earnings levels.

The present benefit formula does not generally produce benefits that replace the full amount of net take-home pay. Except at the very lowest earnings level, it does not enable retirees to maintain their previous standard of living entirely. For a low-wage worker who consistently earned about half the average wage, the basic annual benefit for a worker retiring in 1981 represents about 53 percent of earnings in 1980 and about 66 percent of net take-home pay (Table 7-2). For a person who always earned the average wage, the comparable figures are 41 and 56 percent. For one who always earned the maximum amount that is taxable under Social Security, benefits are 25 percent of preretirement earnings and 38 percent of net take-home pay. These percentages apply to an individual worker's benefit. A married couple receives more, though not necessarily a higher proportion of the combined earnings of husband and wife when both worked for pay. Most people have varying earnings patterns over their working lives, but the general structure of benefits and the relation of benefits to previous earnings are effectively portrayed in Table 7-2.

TABLE 7-2

BASIC BENEFITS UNDER PRESENT LAW FORMULA; EARLY 1981 a/

Annualized Average Indexed Earnings	Earnings in 1980 b/	Annualized Basic Benefit c/	Annualized Basic Benefit as Percent of Earnings in 1980	Annualized Basic Benefit as Percent of Net Take-Home Pay in 1980 d/
$2,000	$2,165	$1,793	83%	96%
4,000	4,329	2,748	63	76
5,759	6,233 e/	3,308	53	66
8,000	8,658	4,026	47	61
10,000	10,823	4,668	43	58
11,518	12,466 f/	5,152	41	56
14,000	15,377	5,946	39	55
15,624	20,000	6,412	32	47
16,080	25,900 g/	6,480	25	38

a/ Basic benefit is the PIA (Primary Insurance Amount) calculated in early 1981 for a worker attaining age 62 then; workers retiring at age 62 in 1981 would receive benefits reduced by 20 percent; workers retiring at age 65 (in 1984) could have higher benefits (without regard to the cost-of-living adjustments for three years) as a result of increased earnings.

b/ Assumes that earnings which produced the specified AIME moved, over the years, in the same relative manner as nationwide wages.

c/ Not taking into account the benefit increase for June 1981.

d/ Assumes a relationship between net take-home pay and gross earnings the same, on the average, as that shown in Table 7-l.

e/ Represents a low-wage worker who consistently earned about half the average wage.

f/ Represents a worker who always earned the average wage.

g/ Represents a worker who always earned the maximum taxable amount.

In evaluating the adeqacy of Social Security benefits for those who earn above-average wages and whose Social Security benefits are far below a full replacement, it must be recognized that they often receive private or governmental pensions as well as Social Security benefits. According to a Bureau of the Census survey, pension coverage is closely correlated with earnings. While only IO percent of the workers earning less than $5,000 in 1978 were covered, between 70 and 80 percent of those earning $15,000 or more were covered. 2/

The higher income groups, who do not have to spend so much of their income on necessities, have greater amounts of personal savings. In addition, Federal tax policies provide incentives for some private retirement savings in the form of Individual Retirement Accounts for workers not covered by pension plans. Keogh plans offer similar savings incentives for the self-employed.

The Commission believes that it should be the policy of the Federal government to encourage individual saving for retirement. To this end, <u>the Commission recommends substantially increasing the present limits on tax deductible contributions to Individual Retirement Accounts</u>.

Because high-earners are likely to have private pensions and/or substantial personal savings, the Commission does not recommend changing the basic formula to raise their Social Security benefits. However, some changes should be made to improve the incomes of low-income

2/ <u>Patterns of Worker Coverage by Private Pension Plans</u> survey by the Bureau of the Census under contract with the Department of Labor and the Department of Health and Human Services. U.S. Department of Labor, Labor-Management Services Administration, Pension and Welfare Benefit Programs, August 1980.

persons. The Commission is recommending a 25-percent increase in Supplemental Security Income payment levels. This would increase the incomes of aged, blind, or disabled people who have little or no Social Security, few assets, and little other income (see Chapter 11).

The Commission also recommends increasing the special-minimum Social Security benefit for people who have worked in covered employment for many years. This change will-enable low-paid workers, who usually lack pensions or significant savings, to receive more adequate earnings replacement income from Social Security (see Chapter 11).

Wage Versus Price Indexing for New Retirees

The effect of inflation and productivity growth over the years has made earnings received some years ago relatively low in comparison with recent earnings. For example, the nationwide average wage for people employed more or less full-time was $2,799 in 1951, compared with $11,479 in 1979, a 4-fold increase.

Under present law, the past earnings record of each applicant is updated, by indexing it to reflect recent wages, before it is used to determine each worker's average earnings. Specifically, a person who earned $3,000 in 1951 who reaches age 62 in 1981 would be considered to have had earnings of $12,303 in 1951. This amount is calculated by multiplying $3,000 by the ratio of $11,479 to $2,799. Private pension plans and public employee retirement systems (such as Civil Service Retirement) solve the problem of wage-level changes over a worker's lifetime by using an average-final-salary basis, such as the highest three consecutive years. In a national social insurance system like Social Security, which covers workers with many diverse employment patterns, the same general results can be obtained by indexing each past year's earnings, so as to make them comparable with recent general earnings levels. For example, to update 1951 earnings to 1979 would mean multiplying them by a factor of about 4. Such procedure is called wage indexing. Then, the indexed earnings for a long period of years can be averaged, so as to yield a meaningful average earnings level on which to compute benefits. This is what is now done under Social Security.

There is a second component in the indexing procedure. Each year, as each new group of persons reaching age 62 has their past earnings updated, the benefit formula for this group is also updated. This is done by raising the AIME ranges in the basic benefit formula by the change in economy-wide wage levels (see footnote 1 in this chapter).

A different indexing procedure has been suggested by some. The past earnings record would be updated not by the increase in wages but by the increase in the Consumer Price Index over past years; and the dollar amounts of the AIME used in the basic benefit formula would likewise be adjusted by the increase in the CPI. (Alternatively, proposals have been made to price index only the earnings record or only the AIME ranges in the formula, rather than both -- and to index the other element by wages.) Because prices normally rise less rapidly than wages, the price-indexing method will not bring past earnings up to recent levels.

Under the present wage-indexing procedure, workers with average earnings throughout their working lifetimes will receive a basic benefit at 65 that replaces about 40 percent of recent preretirement earnings.

This will occur regardless of whether the worker reaches 65 in the near future or many years hence.

By contrast, under price indexing if, as expected, wages rise more rapidly than the CPI, the benefit will replace a lower percentage of preretirement earnings for those who retire many years hence than for those who retire in the near future. Ultimately, the replacement rate for the average earner may drop to as low as 25 percent. This price-indexing method would produce much lower benefits in the long run for workers at all earnings levels -- and thus much lower costs for Social Security.

The Commission opposes the price-indexing approach for a number of reasons. Price indexing does not represent proper pension planning, because relative benefits will be lower, and unpredictably so, for long-term workers who retire many years in the future than for current retirees . Declining relative benefits have never been considered suitable in private plans. To younger generations such a policy is unfair. They would pay higher tax rates for a longer period of time and would receive lower relative benefits when they retire than does the current older generation. Some proponents of the price-indexing method argue that the Congress would, and should, change the situation in the future so that the declining relative benefits would never really occur. In that case, the projected savings of the price-indexing approach would not occur either. The Commission does not believe that Congress should institute a plan that is known to be defective and will need to be changed.

The present procedure of computing benefits by indexing past earnings records and the benefit formula to wages produces stability in future benefit levels. People should be able to know in advance, what to expect from Social Security so they can plan to meet their remaining future needs through private pension plans and individual savings.

Adjusting Benefits After Retirement

Under present law, after a beneficiary receives his or her first check, benefits are adjusted to keep pace with inflation whenever the Consumer Price Index (CPI) rises by 3 percent or more. This is called the "automatic adjustment" provision, enacted in 1972 to avoid the need for Congress to adjust benefits every few years. The Commission recognizes that inflation-proof benefits are an important source of security and it believes that they should be continued during normal economic times.

During most of this century, rising prices have been matched or outdistanced by rising wages, and active workers have made gains in their standards of living. But in recent years prices have risen faster than wages, and the automatic 100% inflation adjustment has placed a severe financial strain on the Social Security system. For the first quarter of 1979, prices rose by 9.9 percent as compared with the first quarter of 1978, while wages rose by only 7.2 percent. In the following year, inflation was worse: prices rose by 14.3 percent, while wages rose by 8.4 percent.

When economic stagnation persists, it is necessary to limit the automatic benefit increases. When wages do not keep up with inflation, it is not equitable to ask workers whose own standards of living are deteriorating to pay even higher taxes to assure 100% inflation-proof benefits for those receiving Social Security.

The Commission recommends that the automatic adjustment of benefits to the CPI should be modified if over a two-year period, the average increase in the CPI exceeds the average increase in wages, and if the increase in the CPI applicable to the current year is at least 5 percent. During this period, the increase should be limited; it should be the increase in the CPI for the past year, reduced by the excess of the 2-year average annual rise in CPI over that in wages. When wages once again rise faster than prices, the lost benefit increases would be restored.

Table 7-3 illustrates how this plan would work, assuming it had gone into effect in 1979. Under present law, benefits were increased by 14.3 percent effective in June and payable in July 1980. Under the Commission's recommendation this benefit increase would have been 10.0 percent.[3/]

3/ This is calculated by first taking the 2-year average of price increases and of wage increases for 1979-80. The average of price increases (9.9 and 14.3) is 12.1 percent. The average of wage increases (7.2 and 8.4) is 7.8 percent. The excess of price over wage increases for the period is 4.3 percent (12.1 minus 7.8). This is the amount by which the automatic increase of 14.3 percent in 1980 would have been lowered, yielding a benefit increase of 10.0 percent. The restriction that the current year's CPI increase must be at least 5 percent would have no effect in this case.

TABLE 7-3

ILLUSTRATION OF COMMISSION'S MODIFICATION OF AUTOMATIC-ADJUSTMENT BENEFIT PROVISION

Year	Present Law Benefit Increase Based on the CPI a/	Increase in Wages b/	Commission's Proposal: Adjustment in Benefit Increase c/	Commission's Proposal: Benefit Increase Payable
	(1)	(2)	(3)	(4)
1978	6.5%	8.1%	*	*
1979	9.9	7.2	-.6%	9.3%
1980	14.3	8.4	-4.3	10.0
1981	10.1	9.7	-3.2	6.9
1982	9.8	9.8	-.2	9.6
1983	8.2	8.6	+.2	8.4
1984	7.3	8.0	+.6	7.9
1984	6.4	7.5	+.9	7.3

* Not applicable.

a/ These are the automatic benefit adjustments under present law. They are based on first-quarter data; 1978-80 are actual data, while later years are the assumptions in OMB's 1980 Mid-Session Review.

b/ For 1978-80, these are based on first-quarter data, using the hourly earnings index for production or non-supervisory workers on private non-agricultural payrolls, developed by the Department of Labor; for later years, the assumptions as to changes in covered wages in the Office of Management and Budget's 1980 Mid-Session Review are used.

c/ This is calculated by first taking the 2-year average of CPI increases in column (1) and of wage increases in column (2). The amount by which the CPI average exceeds the wage average is shown. When this amount is negative, the automatic benefit increase is lowered by this amount. When wages again rise faster than prices and this amount is positive, the automatic benefit increase is raised by this amount until the full amount of lost benefit increases has been restored.

The lost benefit increase would be restored on a cumulative catch-up basis when the economy returned to normal times. For example, in the illustration shown in Table 7-3, the automatic increase would be limited in 1980-82, but then would be restored beginning in 1983 and would be fully restored several years after 1985.

If this had been in effect after 1978, it would have prevented the short-term financing problems facing the program in 1982-85. The trust fund balance would have remained substantially above $25 billion, and the year-end fund ratios would have been no lower than 18 percent. Table 7-4 shows how this plan, if it had been effective after 1978, would have affected the balance in the OASDI Trust Funds.

The Commission's proposal cannot be put into effect until 1981 at the earliest and more likely not until 1982. Thus, it cannot solve the existing financial problem of the Old-Age and Survivors insurance Trust Fund. However, the proposal can prevent (or, at the least, ameliorate) such problems in the future, if prices again rise more rapidly than wages over several consecutive years. A/

A/ See supplementary statements on CPI indexing by Mr. Laxson, and Mr. MacNaughton; and by Mr. Cohen, Ms. Duskin, and Ms. Miller.

TABLE 7-4

COMBINED OASDI TRUST FUNDS IF COMMISSION'S MODIFICATION OF AUTOMATIC-ADJUSTMENT PROVISION HAD BEEN IN EFFECT AFTER 1978 a/

(figures in billions)

Calendar Year	Income	Outgo	Excess of Income over Outgo	Fund at End of Year	Fund Ratio
1979	$105.9	$107.0	-$1.12	$30.6	30%
1980	119.6	121.2	-1.6	29.0	25
1981	136.3	136.3	--	29.0	21
1982	154.8	151.9	+2.9	31.9	19
1983	172.5	170.1	+2.4	34.3	19
1984	191.8	189.0	+2.8	37.1	18
1985	222.5	208.6	+13.9	51.0	18 b/

a/ The calculations are based on the latest economic assumptions used in the Office of Management and Budget's Mid-Session Review in mid-1980. Considering OASDI as a whole makes the tacit assumption either that inter-fund borrowing is authorized and occurs or that the OASDI tax rate is reallocated between OASI and DI to provide each with about the same relative financing throughout the period.

b/ The fund ratio at the beginning of 1986 is estimated to be 22%.